



WORKING DRAFT: STATE INCOME TAXATION of PARTNERS AND PARTNERSHIPS
MTC STAFF MEMO – CONTEXT AND ISSUE OUTLINE
CURRENT AS OF MARCH 15, 2021

NOTE: The primary revisions to this working draft are: (1) The section under Important Federal Partnership Tax Concepts – No. 10 – International Tax Provisions, starting at page 27 and (2) the Issue Outline, Issues Related to Sale of a Partnership Interest, starting at page 40.

The purpose of this working draft is to aid discussion of state partnership tax issues as part of the MTC uniformity process. This draft is divided into two main parts – General Context for State Taxation and the Issue Outline.

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NOTE: “Partnership” and “partner” refer to business entities and their owners subject to IRC Subchapter K (§§ 701-. Specific terms including “general partnership,” “limited partner,” etc., refer to specific types of entities or their owners.

INTRODUCTION

State partnership tax rules have been described as “underdeveloped.” This staff memo contains an issue outline—summarizing the questions that state rules should address. But first, it discusses the important context that may fill in the answer when those rules are silent or provide a overarching structure for a system of partnership taxation.

GENERAL CONTEXT FOR STATE PARTNERSHIP TAXATION

Legal and economic factors specific to partnerships have influenced the federal partnership tax system and may sometimes determine the outcome of certain federal tax issues. These same factors, along with federal tax conformity, can also determine the outcome of state tax issues.

1. Aggregate Versus Entity Theory

Partnerships were first recognized under the common law. Traditionally, they were treated as a collective or aggregate of persons having joint rights. Later, partnerships began to be treated as entities in certain contexts. Both the aggregate and entity theories of partnerships influenced the development of the state statutory law that now governs partnerships. Those theories can also be seen in the Internal Revenue Codes (IRC) Subchapter K.

A. Aggregate Theory – The partners jointly own an undivided interest in the partnership assets, collectively make decisions, and are personally bound by the partnership’s actions. Pass-through taxation of partnership

income, where each partner recognizes and pays tax on a share of the items making up that income, is an example of the aggregate theory in practice.

B. Entity Theory – Partnerships own their asset and make decisions, generally through a management structure, which bind the partnership but not the partners personally. Entity theory simplifies the manner in which partnerships can operate and deal with third parties. In the federal pass-through system, tax items are tracked and characterized at the partnership level and these attributes flow through to the partners—which is an example of entity theory in practice.

C. Examples Where Courts Looked to Entity Theory –

(1) *Centex Int'l, Inc. v. Dep't of Revenue*, 750 S.E.2d 65 (2013), holding that a tax credit available to a “corporation” could not be claimed by a corporate partner of a partnership since the partnership was the entity engaged in the acts that qualified for the credit.

(2) *Bell Atl. NYNEX Mobile, Inc. v. Comm'r of Revenue Servs.*, 273 Conn. 240, 242-243, 869 A.2d 611, 613 (2005), holding that a partnership is not a “taxpayer” (even though its partners may be) and therefore cannot claim a tax credit to pass through to its partners.

2. Economic Substance

When partnerships were first recognized under the common law, a partnership's existence was determined from the partners' actions and their objective economic effects. The federal tax rules were developed to track this general context. Over the years, IRC Subchapter K has continued to seek to match the tax result with the real economic substance of the partners binding economic agreement.

- A. Example – “Substantial Economic Effect.” IRC § 704(b) requires tax items be allocated to the partners in a way that has substantial economic effect. This means that the allocation must match the partners' real and binding agreement to share in the related economic benefits and costs.
- B. Example – IRC § 752 looks to whether partnership liabilities are truly recourse or non-recourse debts when giving partners credit for these liabilities in computing their partnership interest tax basis.
- C. Example – Subchapter K has a number of so-called “anti-abuse” rules which set the boundaries for when the other statutory rules will apply and prevent abuse of those rules—particularly where the goal is to use a partnership to change the tax result of a transaction or interaction between taxpayers. One anti-abuse rule, referred to as the abuse-of-entity rule, prevents persons from asserting that a partnership exists or that income or transactions are partnership-related when there is no real partnership relationship.

3. Partnerships Distinguished from Other Persons

Partnerships may be treated differently than corporations or individuals under certain legal doctrines. Such distinctions may indirectly affect tax matters.

One important area where partnerships have been distinguished for different treatment involves adjudicatory jurisdiction. Such jurisdiction may have an indirect effect on the ability of states to impose withholding or information reporting requirements.

- A. Example – *Carden v. Arkoma Assocs.*, 494 U.S. 185 (1990), holding that federal diversity jurisdiction requires all partners, both general and limited, to be diverse.
- B. Example – *Lurie v. 8182 Maryland Assocs.*, 938 P.2d 676 (Mont., 1997), holding that Montana could not assert general jurisdiction over a limited partnership on the basis of a limited partner's residence there.
- C. Example – *Waller Marine, Inc. v. Magie*, 463 S.W.3d 614 (Tex. App. Houston [14th Dist.] 2015), holding the presence of a partnership, unrelated to the matter in suit, cannot support specific jurisdiction over a nonresident partner.
- D. Example – *Renda v. Peoples Federal Savings & Loan Ass'n*, 538 So.2d 860 (Fla. 1st DCA 1988), holding a court does not have long-arm jurisdiction over limited partners, who were analogous to stockholders, by virtue of the partnership's actions in the state. (This case was cited in *Lanzi v. Al. Dept. of Revenue*, 968 So. 2d 18 (Ala. Civ. App. 2007), discussed further below.)

4. Authority of State Law – Generally

NOTE: The model state laws governing partnerships are discussed in more detail later in this memo. Here, we note simply that state tax law provides the critical context for determining what a partnership is, as well as what certain actions or transactions mean, which can also determine the ultimate tax outcome.

- A. Generally – Like corporations, partnerships are creatures of state law. State common law or statutory law, therefore, determines the nature, rights, duties, and obligations of partners and partnerships with respect to each other and to third parties. Many states have adopted versions of the Uniform Law Commission (ULC) model statutes governing the creation and treatment of various partnership forms, discussed in more detail later.
- B. Influence on Federal Tax Issues – The federal courts recognize that some federal tax issues can only be resolved by looking to the state law governing partnerships, which not only defines partnerships and how they are formed, etc., but may fill in the gaps in partnership agreements.
- (1) *Example: Fuchs v. Commissioner*, 80 T.C. 506, 512 (1983), holding that the Uniform Partnership Act (adopted generally by the majority of states) determines what events constitute dissolution of a partnership, and therefore determined when a federal tax election could be made by a partner versus the partnership.
- (2) *Example: Jackson v. Commissioner*, 42 T.C.M. 1413, 1419 (1981), noting that to determine the proper treatment of a transfer of interests in a joint venture, it was necessary to look to California partnership law, and provisions in the law which allowed partner to transfer either full ownership rights or lesser interests and which allowed the

partnership to continue even after a partner transferred an ownership interest.

- C. Influence on State Tax Issues – As in the case of the application of federal tax rules, states must often refer to state statutes governing partnerships in order to make important state tax determinations.
- (1) *Example: Matter of Megson v. New York State Tax Commn.*, 105 A.D.2d 481 (App Div, 3d Dept 1984), rejecting an argument by the taxpayer that his sale of a partnership interest terminated the partnership prior to his becoming a resident in the state and concluding that Subchapter K's rule for when a partnership terminates depended on provisions in the model partnership act adopted by that state and the partner's previous state of residence.
- (2) *Example: In re Allcat Claims Serv., LP*, 356 S.W.3d 455 (Tex. 2011), holding that, under the entity theory embodied in the revised uniform partnership act, which Texas has adopted, the Texas Franchise Tax does not violate the state constitution's prohibition against taxing the income of individuals because the tax falls on the entity.
- (3) *Example: Perkins v. Oklahoma Tax Commission*, 428 P.2d 328 (1967), holding, as other states had, that under the uniform model act, a partnership interest is an intangible asset for estate tax purposes.

5. Federal Tax Conformity

NOTE: The last factor affecting state partnership taxation is the federal tax law—which is also discussed in more detail in the following sections. Here, we note that the extent to which a state’s income tax conforms to the IRC, in general, and Subchapter K, in particular, will provide the answer to many state tax questions.

A. Pass-Through Versus Entity Taxation – There are significant differences between systems that use a pass-through approach to tax partnership income versus entity-level taxation.

(1) *Pass-Through Taxation.* Pass-through taxation refers to a system under which owners pay tax on the entity’s current income. But this idea is deceptively simple.

(a) **General Policy:** The IRC contains various substantive tax rules that govern how individuals and corporations will be taxed based on the attributes of the taxpayer and the character of the items of income, expense, gain, or loss that is recognized. The policy behind pass-through taxation is that these substantive tax rules and partner-specific attributes should apply consistently whether the partner earns or incurs the tax item directly or through the partnership. In other words, the use of a partnership should not affect the application of these substantive rules.

(b) **Substantive Tax Rules:** Under the pass-through system, the tax rules governing character, value, timing and recognition, and other tax treatment of transactions and activities are applied at entity level and then this substantive tax information passes through to the owners.

Example: Assume a partnership sells an asset. The substantive tax rules apply at the partnership level to determine whether or not there is gain or loss and how much, when any gain must be recognized, and whether it is treated as a short- or long-term capital gain or ordinary income. If the partnership determines that it must recognize \$100 of long-term capital gain in the current year, then the partners will also report their share of this \$100 as long-term capital gain in the current year.

(c) **Partner-Specific Attributes:** The partner’s own tax attributes—tax bracket, other taxable income, expense, gain, loss, etc.—will also apply to determine the tax owed.

Examples: A partner in a lower tax bracket or who has capital losses from other sources may pay less tax on her share of a partnership’s capital gain than another partner who is in a higher bracket or has no other offsetting losses.

(2) *Entity Taxation.* When tax is imposed at the entity level, partner-specific attributes that might affect the tax calculation will be lost. Some states impose an entity-level tax on partnerships in addition to that imposed on partners, but such a tax may also be imposed in lieu of tax on partners.

(a) **Tax Imposed in Addition:** An entity-level tax, in addition to tax on the partners, may be imposed without disturbing the pass-through tax on the partners. The effect, however, will be different than the effect of tax on corporations and shareholders since shareholders do not pay tax until corporate income is distributed whereas partners pay tax on the partnership’s current income.

(b) **Tax Imposed in Lieu:** Recently, in response to Congress capping the state and local tax deduction, states have allowed

partnerships to elect to be taxed on their income at the entity level, with a credit allocated to the partners for their use against the state tax imposed on their share of that same income.

B. Other Effects of Federal Tax Conformity Generally – In addition to whether a state conforms to pass-through treatment of partnership income, whether a state conforms to federal tax law generally can have direct and indirect effects on state taxation of partnerships.

(1) *Example* – States will likely use the IRC § 761 definition of a partnership, rather than the general state law provision which governs partnerships and is narrower. In limited circumstances, therefore, a joint undertaking might be taxed as a partnership even though it doesn't qualify as a partnership for other purposes under state law.

(2) *Example* – Where a state decouples from the federal treatment of particular items (e.g. depreciation), it may need to require either the partnership or the partners to make the necessary adjustments, to ensure tax will be reported properly by resident and nonresident partners even if the partnership itself is jurisdictionally remote.

6. Summary

These five main factors – (1) aggregate versus entity theory, (2) economic substance, (3) partnerships distinguished from other persons, (4) authority of state law, and (5) federal tax conformity – may determine or affect the answers to many state tax questions in the partnership area. Aspects of the last two of these factors – state partnership law governing partnership forms and federal tax law – are discussed further below.

PARTNERSHIP FORMS AND STRUCTURES

As noted above, state law controls partnership forms. This section discusses what it means to be a partner, different partnership forms, and affiliated partnership structures. These structures can be extremely complicated. This, in turn, complicates pass-through taxation of partnership income.

1. State Governing Statutes

- A. Mandatory Versus Default Rules – States statutes allow formation of different types of partnerships. These statutes contain *mandatory and default rules*.
- (1) Mandatory rules provide a basic definition for that particular form, which entities must fit, or they impose certain rights and duties, which cannot be altered without changing the partnership form.
 - (2) Default rules create a framework where partnership agreements are silent and can be, and often are, altered by the owners through agreement without changing the basic form.
- B. Choice of Law – It is the law of the state in which the partnership is created that determines the partners' general rights and duties with respect to the partnership, based on its form, and the partnership's relationship to third parties. The state in which the partnership is created is often called the "jurisdiction of formation."
- C. Federal Securities Law is Generally Inapplicable – The federal law regulating securities markets will generally not be applied to partnerships unless that application is explicitly provided for. See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148 (2008).

2. Inherent Flexibility

As compared to corporations, partnership structures provide much more flexibility, allowing owners not only to make differing contributions and have differing roles, but also to share in the partnership economic benefits and obligations in different ways.

Example – Individuals A, B, and C form a partnership. A contributes real property, B contributes cash and agrees to oversee the rental of that real property, and C agrees to underwrite financing to obtain funds for improvements. A, B, and C may share rents, expenses, gains, losses, and liability for partnership debts in different proportions, reflecting their negotiated economic arrangement.

3. Terms for What it Means to be a Partner

Various terms are commonly used to refer to basic rights and duties of partners. Usage of these terms is often informal or imprecise. Below is a summary of the most important terms and how they will be used here.

- A. Ownership (Generally) – "Ownership" simply refers to a partner's role in and legal relationship to the entity—the proverbial bundle of rights—as distinguished from other third-parties.
- B. Ownership Share, Ownership Interest, or Capital Account – "Ownership share" or "ownership interest" is used in state law and elsewhere to refer to the share of partnership assets a partner would receive from a hypothetical current liquidation. These terms are often mistakenly conflated with control or distributive share. Ownership interest may be represented by the partner's share of the book-value of partnership capital, that is, assets minus liabilities using financial accounting rules.

- C. Majority or Minority Partners – A “majority” partner is a partner whose ownership share exceeds 50%. As used here, a “minority” partner is a partner whose ownership share is 50% or less. A partnership may have no majority partners.
- D. Control and “Equal Partners” – “Control” refers to the right of partners over significant partnership actions including significant transactions, changes in the partnership, the appointment of managers, etc. Control may be vested in one partner or shared. It is generally represented by voting share, but control is ultimately determined by state law and the agreement of the partners and control arrangements can vary widely. Control is *not* necessarily tied to ownership share. Control over certain specific partnership actions may also vary. Sometimes the term “equal partners” refers to a partnership in which all partners have an equal vote on partnership matters.
- E. Management – “Management” as used here refers to the day-to-day oversight and direction of partnership activities. The management of a partnership may be done directly by partners or may be done through appointed managers.
- F. Active Versus Passive – Partners who perform the partnership’s business activities are generally referred to as “active.” A partner may have an active role in the business without having significant control. A partner can also be an active minority partner or a passive majority partner. (Although a limited partner that is “active” may be subject to certain types of liability.)
- G. Limited – The term “limited,” when used to refer to partners or partnerships generally refers to protection from liability but as noted above, to retain that limited liability, state law may impose other requirements, including the requirement that the limited partner not take an active role in the business. But in some partnership forms, a partner can be a majority, controlling, active partner and still have limited liability.
- H. Distributions and Distributional Interest – For both general law and tax purposes, a “distribution” is an actual transfer of assets from the partnership to one or more partners. In state law, the partners’ shared interest in or right to distributions is referred to as the “distributional interest.”
- I. Distributive Share – In contrast with “distribution,” the term “distributive share” is used under Subchapter K, and often generally, to refer to the portion of the partnership’s income and expense that will be credited/debited to particular partners’ capital accounts, increasing or reducing the partners’ ownership shares.
- Example: Smith, a partner in Partnership X, is entitled to receive, as a distributive share, 50% of the partnership rental income. In Year 1, the partnership has \$100,000 of rental income. Smith has a distributive share of \$50,000 in Year 1 even if Smith takes no distribution from Partnership X that year.
- J. Partnership Interest – The meaning of “partnership interest” depends on the context. The term most commonly refers to the intangible asset representing the partner’s ownership interest *plus* the partner’s other ownership rights that are transferrable. Under the ULC model acts, the partnership agreement may limit the extent to which some rights (e.g. control) of a partner can be transferred. But IRC § 705(b) also defines a “partner’s interest in the partnership” for purposes of determining whether allocation of partnership items have substantial economic effect.

4. Partners May Act Other than in Their Capacity as Partners

Partners may have relationships with each other or with the partnership that fall outside the partner-partnership relationship. For example, two companies that regularly contract with each other may also form a partnership to do business together. Or, a partner may lend money to a partnership. The ultimate tax result may be different depending on whether the partner is acting as a partner or not. For tax purposes, this determination is based on substance versus form.

5. Importance of Management, Transferability, Continuity, and Liability

Partnership forms vary from corporate forms, and from each other, primarily in terms of their management, the transferability of ownership and continuity of entity, and the liability for partnership debts.

- A. Management – Traditionally, general partnerships operated as collectives requiring a majority vote for the partnership to act. At the other extreme, LLCs may appoint a non-owner manager, with all owner-members taking only a passive investment role in the LLC.
- B. Ownership Transferability and Continuity – Traditionally, transfer of a partner’s interest might cause dissolution or discontinuation of the partnership, triggering other requirements, including tax filing. Today partnership interests may be transferred without affecting continuity.
- C. Liability – Traditionally, general partners might be personally liable, or liable jointly and severally, for the debts or partnership obligations. Liability limitations are common now in all partnership forms. Even where the form of partnership may allow for limited liability, partners may separately guarantee the debts of a partnership.

6. Different Partnership Forms Under the ULC Model Acts

- A. Common Forms – The Uniform Law Commission (ULC) and many states have recognized different forms of partnerships which include, most importantly:
 - (1) *General Partnership (GP)* – A traditional form of partnership that provides collective management and no limitation on liability.
 - (2) *Limited Liability Partnership (LLP)* – A GP that elects to provide limited liability for certain partners that are not active or engaged in partnership management.
 - (3) *Limited Partnership (LP)* – A non-GP form of partnership that traditionally provided limited liability for all partners not participating in control or management.
 - (4) *Limited Liability Limited Partnership (LLLP)* – An LP that provides elective limited liability for all partners (including controlling partners).
 - (5) *Limited Liability Companies (LLC)* – A form of partnership that, like LLLPs, also provides limited liability for all owners (“members”) of the company and may provide for management by a non-member.
 - (6) *Single Member LLC (SMLLC)* – An LLC that has only one member and is “disregarded” for tax purposes (treated as a division of its owner), or may be treated as a C corporation if the SMLLC so elects.
 - (7) *Series LLCs* – An LLC that issues different membership shares to different owner groups reflecting rights in different sets of assets so that each series is treated as a separate LLC for certain purposes.

B. ULC Models – Common Provisions – For every form of partnership, the ULC models typically:

- (1) Define the basic requirements to meet the form of partnership.
- (2) Define how the partnership is formed and whether filings are required.
- (3) Impose certain duties (care, loyalty, etc.) on the partners.
- (4) Require the partnership to keep records and to allow a partner to inspect those records.

C. ULC Models - Major Differences –

- (1) *Mandatory versus Default Rules.* As noted above, the ULC models commonly provide both mandatory and default rules for the particular forms of partnerships which they govern.
- (2) *State Variation.* As with all model acts, states may vary provisions of the ULC model acts when they adopt those acts. Often times, these variations affect which provisions are mandatory and which apply only if the partnership agreement is silent.

7. ULC Model Acts

A. General Partnership (GP)

- (1) *The ULC Model Act* – The ULC model Uniform Partnership Act establishes rights and duties of partners in a GP. The ULC has amended the act over time, substantially revising it in 1997. See the current version of the model act on the ULC’s website, here: <https://www.uniformlaws.org/viewdocument/final-act-with-comments-118?CommunityKey=52456941-7883-47a5-91b6-d2f086d0bb44&tab=librarydocuments>). This revised version of the UPA is referred to as the Revised Uniform Partnership Act, or RUPA, last amended in 2013.
- (2) *Widespread Adoption.* Prior to revision, almost all states had enacted a version of the UPA. Since the revised act was issued, most states (37 as of today) have adopted that version.
- (3) *No Filing.* GPs, unlike all other forms of partnership, can be created without registration or other public filing. GPs also may not be required to qualify in other jurisdictions in order to do business.
- (4) *Liability.* All partners have joint and several liability for partnership debts, however, a judgment against the partnership is not a judgment against a partner.

B. Limited Liability Partnerships (LLP)

- (1) *Provided for Under the RUPA (see above)* – The ULC model RUPA, which permits formation of GPs, also allows for the partnership to elect to be a limited liability partnership. See RUPA, Art. 9.

- (2) *Liability of Partners may be Limited* – RUPA Sec. 306(c) provides for a corporate-styled liability shield that protects some partners of the GP from personal liability for partnership obligations incurred while a partnership is an LLP.
- (3) *Registration and Filing Requirements* – The partnership must register and file annual reports to become an LLP.
- (4) *Qualifying to do Business in Other Jurisdictions* – The RUPA has a “doing business” provision that governs when a foreign LLP must register with another state or file annual reports. This rule allows substantial activity in a state before this requirement is triggered and also applies only to the entity—but this lenient standard explicitly does not limit state jurisdiction.

C. Limited Partnerships (LPs) and Limited Liability LPs (LLLPs)

- (1) *The ULC Model Act* – The ULC adopted the Uniform Limited Partnership Act (ULPA) in 2001 (last amended 2013). The provisions of this act were previously part of the Uniform Partnership Act, but the ULPA is now a stand-alone act. See the latest version of the model on the ULC’s website, here: <https://www.uniformlaws.org/viewdocument/final-act-with-comments-108?CommunityKey=d9036976-6c90-4951-ba81-1046c90da035&tab=librarydocuments>.
- (2) *Widespread Adoption* – About half of the states have adopted the ULPA.
- (3) *Liability Protection at Creation* – Unlike an LLP, an LP is created from the outset in a form that gives all but the general partner(s) limited liability for partnership debts.

- (4) *Election for LLLP Status* – The ULPA provides that LPs may also elect to give any general partner who would otherwise have liability a shield against that liability.
- (5) *Requirement to Register and File Annual Reports* – As with a GP that elects to be treated as an LLP, a LP, whether or not electing to be an LLLP, must register with the state of formation and must file annual reports.

D. Limited Liability Companies (LLCs) and Single Member LLCs (SMLLCs)

- (1) *The ULC and ABA Model Acts*. The ABA first drafted a model act for the formation of LLCs that was adopted by a number of states. The ULC then drafted a model that was closer in form to its other model acts. In 2006, the ULC issued a revised version of this model, referred to as the Revised Limited Liability Company Act (RLLCA). The most recent version of the RLLCA is available on the ULC website, here: <https://www.uniformlaws.org/viewdocument/final-act-with-comments-109?CommunityKey=bbea059c-6853-4f45-b69b-7ca2e49cf740&tab=librarydocuments>.
- (2) *Adoption*. Slightly less than half the states have adopted the ULC version of the model act, although all states have some form of statute allowing the creation of an LLC.
- (3) *Reasons for the LLC Form*. LLCs were created to provide for a non-corporate entity, taxed as a partnership, that would not be dissolved with changes in ownership, could be managed by member owners or by a non-member manager, and provided liability protection for all members.

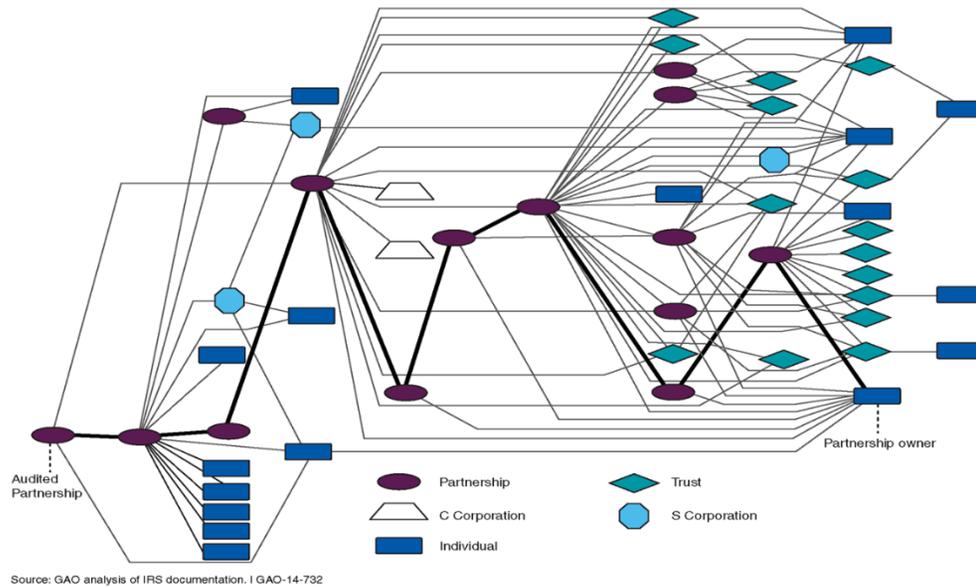
- (4) *Filing of a Certificate or Articles.* LLCs cannot be formed without filing a certificate or articles of organization with the state. This filing is much simpler than for forming a typical corporation.
- (5) *Operating Agreement.* The organic document for the members of an LLC is called an operating agreement. The operating agreement serves the same purpose as a partnership agreement but observes the form of the LLC.
- (6) *SMLLCs.* An LLC can have a single member. SMLLCs have a particular federal tax treatment, discussed below. Non-tax reasons to form a SMLLC include the need to further shield or separate assets from potential liability.

- (b) Provides that each segregated group has its own identity, name, right to conduct business, etc. as though it was a stand-alone LLC.
- (c) Obligates the LLC to keep records for each separate series.
- (d) Provides that liability of the series is limited to the assets of that series.
- (e) Gives members of the LLC separate rights as members with respect to each series.
- (f) May have the master LLC itself as a member.

E. Series LLCs

- (1) *Emerging Form.* A minority of states allow formation of an LLC that, once formed, may segregate assets and operations so that members have rights and duties only with respect to those assets and operations. Each series will have its own operating agreement under a master operating agreement for the LLC.
- (2) *The ULC Model Act.* The ULC model act called the Uniform Protected Series Act, adopted in 2017, is available on the ULC website, here: <https://www.uniformlaws.org/viewdocument/final-act-with-comments-121?CommunityKey=11843f3f-6ba5-4010-be96-8c2125fe7d31&tab=librarydocuments>.
- (3) *Aspects of a Series LLC.* Under the ULC model act, a series LLC:
 - (a) Segregates identifiable sets of assets owned by the LLC.

8. Affiliated Partnership Structures



“Partnership structure” is used here, in contrast to the term “form,” to refer to multiple entities that are affiliated or interrelated, in part, through partnership ownership.

A. Flexibility Creates Complexity - There is no limit on the size of partnerships or the number of tiers—that is—partnerships which own other partnerships. As the illustration above demonstrates, this allows creation of large multi-entity structures, often called multi-tiered structures. This complexity, in turn, creates a number of issues that affect taxation:

(1) *Lack of Transparency.* To quote congressional findings in the Corporate Transparency Act: “Very few States require information about the beneficial owners of the corporations and limited liability

companies formed under their laws.” This makes determination of the ultimate owners, who may also be the ultimate taxpayers, difficult—especially where there are multiple related entities.

(2) *General Decentralization.* In complicated structures, it may be difficult to determine which entities or partners are acting, or are required to keep records or provide information, or whether those entities or partners have connections to the state.

B. Opportunity for Abuse – Complexity combined with a lack of transparency and decentralization, as well as the pass-through method of taxation, all create opportunities for noncompliance and abuse.

(1) *Noncompliance.* Because partnerships are not taxed at the entity level, there can be partnerships or other pass-through entity tiers between the entity which engages in actions giving rise to tax items, and the person who will ultimately owe tax on those tax items. This makes tracking, identification, and assessment difficult.

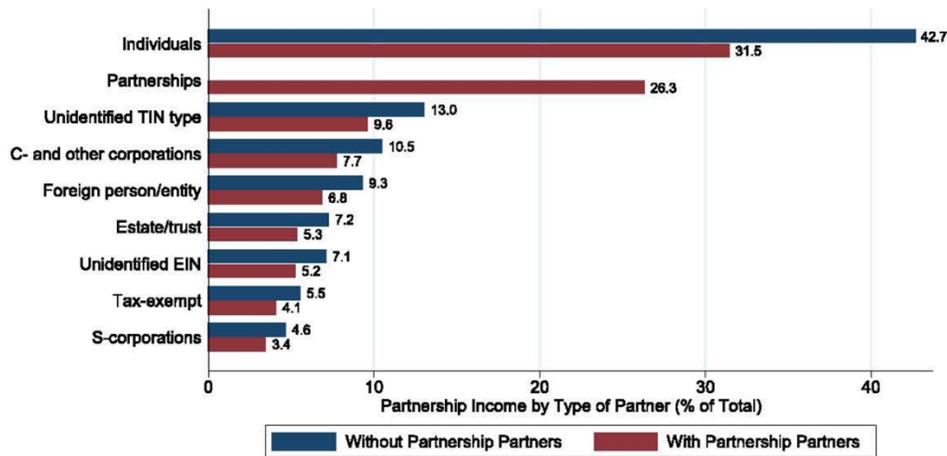
(2) *Abusive Tax Strategies.* Historically, partnerships have been used in a number of federal income tax strategies that have been found to amount to tax evasion or unlawful tax shelters. Many of these strategies have been addressed under Subchapter K and other IRC provisions with so-called “anti-abuse” rules.

C. Intercompany Transfer Pricing - Conducting business in large, complex partnership structures will inevitably require recognition, or imputation, and pricing of inter-company transactions to properly determine the tax effects. The related issues are likely to be more pronounced for states since states typically apply allocation and apportionment and determine taxes owed on an entity-by-entity basis.

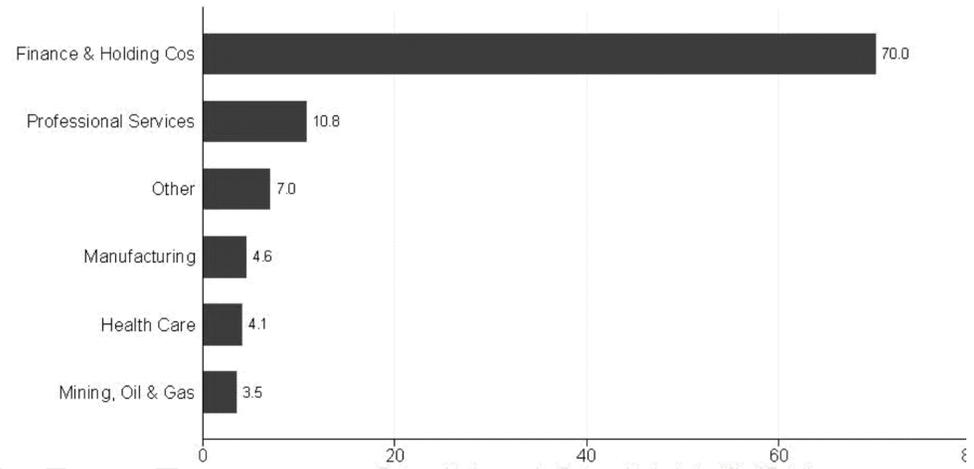
9. Important Data on Partnerships

A 2015 working paper prepared jointly by the U.S. Treasury Department and others sets out data compiled from IRS and other sources on pass-through entities, including partnerships, and the taxes they pay. See “Business in the United States: Who Owns It and How Much Tax Do They Pay?”, Office of Tax Analysis, Working Paper 104, October 2015, available on the MTC website, here: <https://www.mtc.gov/getattachment/Uniformity/Project-Teams/Partnership-Informational-Project/OTA-Business-in-the-United-States.pdf.aspx>.

The data demonstrates the share of income going to different types of partners.



The data also shows the breakdown of partnership income by general industry segment—showing the percentage of the total partnership income earned in each segment.



Note that according to the working draft, while the finance and holding company segment includes real estate and insurance, those categories account for only around 5% of the total income attributed to this industry.

Also, according to the working draft, 69.0% of partnership income, in total, accrues to top-1% households by income. And of this amount, over half accrues from partnerships in the finance and holding company industry and another quarter accrues from partnerships in the professional services industry.

This data illustrates that most of the income that is earned in the partnership form comes from finance and holding company arrangements and accrues to the top 1% of households. But, at the same time, there are a number of small businesses that are conducted in partnership form, although they may not generate significant amounts of income.

IMPORTANT FEDERAL PARTNERSHIP TAX CONCEPTS

This section's purpose is to summarize important federal tax concepts that may affect state partnership taxation. For a more comprehensive discussion of federal partnership rules, we recommend *The Logic of Subchapter K, A Conceptual Guide to the Taxation of Partnerships* by Laura and Noël Cunningham.

1. Terminology

In addition to the terms discussed on page 6, the following terms or concepts, some of which will be discussed at greater length, are used generally in the federal tax context, and in this document they will have the following meaning:

- A. Subchapter K – The IRC Subchapter that provides for how partnership tax items, calculated under other IRC provisions, and other partnership-related transactions and activities are treated by the partnership and the partners, and how the accounting and tracking of certain partner information is maintained to ensure that the partners pay tax properly.
- B. Partnership – An entity required to comply with IRC Subchapter K.
- C. Partner – A person who directly or indirectly owns a partnership.
- D. Direct Partner – A direct owner of a particular partnership.
- E. Indirect Partner – An owner of a partnership or other pass-through entity that, in turn, directly or indirectly, owns a particular partnership.
- F. Tiered Partner – A partnership that owns another partnership.
- G. Tiered Structure – A group of related partnerships where one or more of the partnerships own interests in one or more partnerships.
- H. Contribution – The transfer(s) of money or assets by a person or a partner to a partnership in exchange for ownership interest.
- I. Distribution – A transfer of money or assets from a partnership to a partner with respect to that partner's ownership interest. A liquidating distribution terminates the partner's ownership.
- J. Tax Item – A separate item of income, expense, gain, or loss that goes into both federal and state calculation of partnership net income, with any state adjustments.
- K. Separately Reported Tax Item – A tax item that, under Subchapter K, may have to be reported to partners separately because the item's character affects the tax calculation in a particular way (e.g. exempt income, capital gains, depreciation expense, etc.).
- L. Outside Basis – The tax basis of a partner's partnership interest, determined under IRC § 722, which takes into account contributions and distributions as well as the partner's distributive share of tax items reported over time.
- M. Inside Basis – The basis in partnership assets and the amount of that basis that may be assigned to contributing partners versus other partners.
- N. Capital Account – The calculation of the book (financial statement) value of partnership capital (assets minus liabilities) and the amount of that capital that may be properly assigned to particular partners.
- O. Allocation – Unless otherwise indicated by the context, this term will be used to refer to the partnership's determination of the distributive share of partnership tax items, as reported by the partnership on Schedule K-1s, made to one or more partners.

- P. Substantial Economic Effect – The standard imposed under IRC § 704(b) that allocations of the distributive share of partnership items must meet in order to be respected.
- Q. Partner’s Interest in the Partnership (PIP) – A ratio determined under IRC § 704(b), which takes into account a partner’s share of the partnership capital along with other elements and is used to reallocate tax items if the original allocation does not have substantial economic effect.
- R. Special Allocation – Any allocation of a distributive share of a partnership item that does not match the partner’s interest in the partnership.
- S. Guaranteed Payment – A fixed amount allocated to a partner irrespective of the partnership’s profit. These payments are effectively treated as an expense or other reduction of income by the partnership so that they may reduce partnership income or other positive tax items that may be allocated to other partners.
- T. Built-In Gain or Loss – The difference between an asset’s fair market value and tax basis at the time of some event—typically at the time of the asset’s transfer, including a contribution of the asset to or a distribution of the asset from a partnership.

2. Competing Definitions of a Partnership

- A. State Law vs. Federal Tax Law – As discussed above, state law defines what a partnership is for general purposes. Federal tax law, however, contains a separate definition of what constitutes a partnership. State tax law typically looks to the federal tax definition.
- B. Partnerships vs. Common Ownership or Expense Sharing – Common ownership of property, even income producing property, or agreements to share expenses do not, by themselves, create a partnership for federal tax purposes. For a partnership to exist, there must be a joint profit motive. See Treas. Reg. §301.7701-1.
 - (1) *Impact on tax results.* There are many instances when the tax result under Subchapter K will differ from the tax result if the participants were treated as mere co-owners of property or sharing expenses. There are times when it is advantageous for taxpayers to treat an arrangement as a partnership, even if they are not truly engaged in a for-profit endeavor. In these case, the IRS may apply an anti-abuse rule, known as the “abuse of entity rule,” to disregard the purported partnership. See Treas. Reg. § 1.701-2(e). At other times, where a partnership does exist, the partnership will have filing responsibilities (including elections) in addition to the tax filing requirements imposed on the participants.
 - (2) *Check-the-box rules.* In addition to the definition of a partnership in federal regulations, so-called check-the-box rules will also apply. Under these rules, if the entity’s shares are publicly traded, it will be treated as a C corporation—unless it meets the definition of an investment partnership. All other non-corporate entities will be taxed as partnerships unless they make an election to be taxed as a C corporation. A single-member LLC or similar entity will be disregarded unless it makes the election to be taxed as a C corporation.

3. Partnership Record-Keeping, Accounting, & Tax Reporting

A. Record-Keeping Functions – Under Subchapter K, partnerships must keep records to allow the partnership to properly report information necessary for their partners' tax compliance.

(1) *Partnership Agreement*. The partnership agreement is critical in determining the proper tax treatment under Subchapter K. This agreement maybe, but does not have to be, embodied in a single written document. The partners may have access to records establishing the partnership agreement, but this is not always the case, especially where the partner is a passive, minority, or indirect partner. The partnership must generally have records establishing the partnership agreement, whether or not that agreement is a single written document or must be filed with the state in which the partnership is created or is doing business.

(2) *Business Records*. Partnerships, like all businesses, must produce and maintain reliable business records to substantiate the nature and amount of transactions and activities. Under state law, partnerships are obligated to provide partners with the ability to inspect records and will generally provide information to partners when necessary. However, a passive or indirect partner may often lack real access to partnership records.

(a) *Partner Records*: Not all records necessary for partners to compute their tax will be maintained by the partnership. Instead, the partners themselves would maintain these records. Examples may include:

(i) Information on a partner's transactions with other partners where the parties maintain that the transaction would not affect the partnership.

(ii) Detailed information on a partner's sale of all or a portion of the partner's interest in the partnership.

(iii) Other information on a partner's separate dealings with third-parties who may also have dealings with the partnership.

(iv) Information on the activity of "tiered partners," that is, partnership partners whose activities indirectly affect the taxes owed by the ultimate taxpayer-partners.

B. Accounting - Accounting, as distinguished from record-keeping, refers properly tracking partner accounts and partnership financial or similar information to ensure that the partners are properly sharing in the economic results of the partnership, per their agreement. Examples include:

(1) *Effect of Contributions and Distributions*. The partnership will keep track of any contributions and distributions made by or to partners and the effect that these contributions and distributions have on the partners' capital accounts.

(2) *Distributive Share of Income and Expense*. The partnership will record the allocation of economic results attributed to the partners, whether or not they have any tax effects. These allocations also affect the partners' capital accounts.

C. Tax Reporting – Under Subchapter K, the partnership is responsible for additional tracking and maintaining of information necessary for proper tax reporting. This includes:

(1) *Tax Basis Generally*. With some exceptions (e.g. disguised sales), a partnership takes carryover basis in assets contributed by the partners and the partners also take carryover basis in assets distributed

by the partnership. The partnership must track tax basis in any assets acquired by the partnership in order to properly calculate partnership tax items (e.g. gains on the assets sold).

- (2) *Tax Capital.* Subchapter K requires that partnerships track partnership capital and partners' capital accounts according to certain rules that may be different than the accounting which partnerships do for financial purposes. A common difference is how assets with built-in gains or losses are treated.
- (3) *Form 1065 Information:* Each year, the partnership must properly recognize, value, characterize, and report the current year's tax items and other information necessary to prepare the federal Form 1065.
- (4) *Schedule K-1s:* Each year, the partnership must properly allocate the distributive shares of partnership tax items, as well as guaranteed payments, and report other related information, including capital account balances, to partners on the partners' federal Schedule K-1s.
- (5) *Effects of Changes in Ownership.* The partnership must also track and reflect in its tax capital the effects of changes in partnership ownership where those changes require a restatement of certain items.

4. Note on Tiered Partners

Although a tiered partner does not have to pay tax, that partner must perform record keeping, accounting, and tax-reporting functions. There are a few things to keep in mind about how tiered partners affect the ultimate tax that maybe reported:

- A. Character of Partnership Tax Items Does Not Change – The fact that partnership tax items may pass from a lower-tier partnership through multiple tiered partners to the ultimate taxpayer partner will not generally change the character of the partnership tax items as originally determined by the lower-tier partnership. This can add significant complexity to reporting of tax information.
- B. Related Partnership Transactions – Just as with related corporations, related partnerships may have intercompany transactions or other activities that require tax items to be recognized or imputed and valued.
- C. Reporting Difficulties – While the amounts reported on Schedule K-1s issued by a tiered partner will depend on the Schedule K-1 that the tiered partner received from the partnership in which it is, in turn, a partner (and any lower tiers), the ultimate taxpayer partners will only receive a Schedule K-1 from a partnership in which they are direct partners. Therefore, the tax-reporting by a tiered partnership structure has to be done within a single tax period so that taxpayer-partners receive the information they need to file their own tax returns.

5. Distributive Share of Partnership Items

A. Generally – Under IRC § 704(b) and related regulations, partners may agree to vary the distributive share of partnership items. This creates the necessary flexibility to properly reflect the true economic agreement between the partners. However, this flexibility also creates the potential for abuse. Many of Subchapter K's anti-abuse rules are focused on ensuring that allocations of partnership items have economic substance.

- (1) *Different Tax Items May be Allocated Differently.* This has been said before, but it cannot be stressed too much. Partners often agree to share in specific items of partnership income, expense, gain, or loss in different ways. This will often not be apparent on the face of the partner's tax return—especially the return of a corporate partner.
- (2) *Limits on Special Allocations.* To the extent that the allocation of a partnership item does not match the share of the partner's interest in the partnership (PIP), the item is generally referred to as a special allocation and is subject to limitations and anti-abuse rules.
- (3) *Substantial Economic Effect.* The most important limit on special allocations is that they must have substantial economic effect. While this standard is defined, in detail, by IRS regulations under IRC § 704(b), it is primarily focused on the partners' real and binding agreement to share in the economic benefits and obligations of the partnership.
 - (a) *The Problem:* The problem with the idea of substantial economic effect as a standard is that it looks to the ultimate division of economic benefits and obligations among the partners—where these benefits and obligations may not be actually realized by the partners for years.

- (b) *The Solution:* In order to determine what the substantial economic effect of the allocations may ultimately be, in the present, the federal regulations rely on evidence of a binding agreement among the partners to respect the economic effects as properly represented in the partners' capital accounts.

- (4) *Other Anti-Abuse Rules.* The substantial economic effect standard may, in some cases, not be sufficient to eliminate all forms of abuse. Therefore, Subchapter K and IRS regulations set out other limits on special allocations that may apply.

- B. Partnership NOLs – A partnership may show a net operating loss in a year when its items of expense or loss exceed its items of income or gain. But a partnership does not take an NOL carryover deduction (or a capital loss carryover deduction). Instead, the shares of the tax items flow through to the partners and are reported as part of the partners' own tax returns. If a partner has income in the same year where the partnership allocates to that partner amounts of expense or loss exceeding any allocated amounts of income or gain, then the partner may offset those deductions against the partner's income in that year. If this creates an NOL for the partner, then the partner may carryover that NOL subject to any limitations imposed at the partner-level.
- C. Significance of Ability to Enforce Federal Tax Rules for State Partnership Taxation – States will generally rely on the IRS to enforce federal tax rules with which the states conform. But in 2015, Congress recognized that the IRS has been unable to effectively audit large partnerships and provided the IRS with additional authority. This development may mean that partnership tax compliance will receive new attention by taxpayer-partners and practitioners—and this will put pressure on state tax rules, as well.

6. Differences in Partners Affect Ultimate Tax Paid

NOTE: Partnerships generally determine the treatment of their tax items under the general substantive rules for unincorporated businesses—which would apply, as well, to sole proprietorships.

Various types of persons may be partners, including individuals and married couples, corporations taxed as C or S corporations, trusts, estates, tax-exempt entities, and other partnerships. Under federal tax law, each may be taxed differently on their partnership income, which can affect the total tax ultimately paid on that income.

In addition to federal tax differences between types of partners, this section also summarizes the general state tax differences.

A. Individuals –

- (1) *Federal Tax.* The tax rules for individuals and corporations vary (e.g. tax rates imposed on capital gains, limits on deductions for charitable contributions, etc.). In particular, Subchapter C only applies to corporations. The TCJA enacted IRC § 199A which provides to non-corporate partners a deduction against their partnership income which may be substantial—lowering the effective tax rate for those individual partners significantly. Many states appear to conform to this deduction.
- (2) *State Tax.*
 - (a) Residents generally pay tax on 100% of their income to their state of residence and take a credit for taxes paid to other states.
 - (b) Nonresidents generally pay tax on a source basis—meaning that they allocate or apportion income to where it is earned or where

underlying assets have a situs. In the case of partnership items, as the Issue Outline will discuss, most states require the allocation and apportionment of these items at the partnership level, including the use of partnership apportionment factors.

B. C Corporations –

- (1) *Federal Tax.* C corporations are taxed at the entity level, including some partnerships that elect to be treated as corporations or are publicly traded. The IRC applies substantive tax rules for corporations under Subchapter C that may differ from those applied to individuals or non-corporate businesses. These rules may affect a corporate partner's treatment of some partnership items.
- (2) *State Tax.* States that conform to the federal substantive rules for corporations will generally conform to the corporate partner's treatment of partnership tax items as well. States must also fairly apportion the income of C corporations taxed at the entity level.

C. Trusts and Estates – Most trusts and estates are taxed under the general rules for individuals, but some may not be taxed on income that they currently distribute. Instead, in that case, the beneficiary of will report and pay tax on that income.

D. Tax-Exempt Entities – Partners may also be entities that are exempt from federal or state income taxes.

E. S Corporations – If a state conforms to IRC Subchapter S, the income of entities electing to have that Subchapter apply will not be subject to entity-level taxation but will pass through income to its owners. Electing S corporations must conform to certain strict structural and ownership requirements limitations.

F. Other Partnerships – A partnership that is a partner in another partnership, referred to here as a *tiered partner*, will not pay tax on partnership items allocated to it, but will re-allocate those items to its owners.

- (1) *Federal Tax*. Assuming the tiered partner is not a taxable entity under federal law, the income received from lower-tier partnerships will be re-allocated to the partners of the upper tiers until that income is, finally, allocated to taxable or tax-exempt partners. The items retain their tax characteristics and values through this process. A single member LLC will be treated as a division of its owner (or a Schedule C business if its owner is an individual) unless the LLC makes an election to be taxed as a C corporation.
- (2) *State Tax*. Tiered partners raise two significant questions for state purposes. The first is how inter-company transactions will be treated. The second, and related question, is how a partnership's tax items will be fairly apportioned to the state.
 - (a) Example: Partnership 1, operating throughout the country indirectly owns 60% of Partnership 2, which has its only physical operations in in State B. Partnership 2 licenses intangible property to Partnership 1 to use in its business, reducing income earned directly by Partnership 1. Should Partnership 2 be allowed to allocate all of its income only to the 40% partners?
 - (b) Example: Partnership A operates 100% in State X. Partnership A is owned, in part, by Partnership B, which operates 100% outside State X. Partnership B is owned, in part, by Individual. How should Individual determine the portion of partnership income from Partnership A taxable in State X?

7. Categories of Partnership-Related Tax Items

In addition to differences in how various types of partners may be taxed, and the effect of tiered partners on the tax ultimately owed, certain categories of items arising from partnership ownership will affect the tax owed:

- A. Shares of Partnership Tax Items – A partner must report the distributive share of the partnership tax items allocated to the partner for the tax year as reported on the Schedule K-1.
 - (1) *Individual, Trust, or Estate Partners* – The partnership tax items allocated to individuals, trusts, or estates are taken into account in the partner's tax return under the general rules for individuals having income from an unincorporated business, as if they were earned or incurred directly by the partner. Partnership losses (deductible items over income and or capital losses in excess of gains) are generally deductible as if the items were incurred directly by the partner, but the use of partnership losses may be limited by outside basis in the partnership, at-risk rules, and passive loss limitations. A partner's NOL resulting from partnership activities is generally subject to carryover to be used against future income the partner may recognize, subject to limitations.
 - (2) *Corporate Partners* – The partnership tax items allocated to corporations are taken into account in the partner's tax return under the general rules for corporations, as if they were earned or incurred directly by the partner. As with individuals, losses resulting from partnership ownership are generally deductible as if incurred directly by the partner, but their use may be limited by outside basis, at-risk rules, and, to the extent they apply, passive loss limitations. Unused losses are generally subject to carryover subject to be used against future income the partner may recognize, subject to limitations.

- (3) *NOTE on State Decoupling* – When states decouple from the computation of a tax item, the state adjustment must be reflected in the state partnership return and state K-1s, or must be made directly by the partner’s on their own returns. Some adjustments, particularly depreciation, create differences in tax-basis and differences in gains and losses that might be reported state tax.
- B. Distributions in Excess of Basis – While partnership distributions are generally not taxable, distributions in excess of the partner’s outside basis will be taxed as gains.
- C. Transactions of Partners with Each Other or the Partnership – If partners are determined to be engaging in separate transactions with each other or the partnership, this will affect the tax owed. For example, while contributions generally do not trigger recognition of gain, a contribution of property by one partner which is later distributed to another partner will be treated as a “disguised sale.” Or, for example, a partner who lends money to the partnership may have taxable interest income rather than a tax-free partnership distribution.
- D. Sale/Purchase of Partnership Interests – The sale or purchase of a partnership interest often effects only the parties and not the partnership itself. But this is not always the case. While a discussion of the particular rules is beyond the scope of this summary, suffice it to say that when a partnership has assets that have substantial built-in gains or losses, the partnership may, or in some cases must, track a portion of those gains and losses that should accrue to the period before the transfer of the partnership interest and then make adjustments to the allocation of inside basis among the partners so that future income, gains or losses recognized will be properly attributed to the remaining partners versus the incoming partner. See IRC §§ 743 and 754.

8. General Tax Life Cycle of a Partnership

The tax life cycle of a partnership—its formation, operations—including purchases and sales of assets—and certain partner transactions can be generally summarized as follows:

- A. Formation – Contributions (with certain minor exceptions) are nontaxable events for both the partnership and the partners. IRC § 721. The partner will receive an interest in the partnership in exchange for the money or assets contributed. If assets with built-in gain or loss are contributed, there will be no recognition of that gain or loss. Instead, the partnership will take carryover basis in the assets and the contributing partner will be credited with the fair market value of the assets as part of the partner’s capital. The partner’s contributed tax basis in the asset will also be tracked, so that under Subchapter K anti-avoidance rules, the built-in gain or loss can ultimately be allocated to the contributing partner when the asset is sold by the partnership or distributed. The partner’s outside basis in the partnership interest will reflect the tax basis of the contribution. IRC § 722.
- B. Operation – The partnership will report the results of operations and all the tax items generated, using rules for unincorporated businesses (individual tax rules). IRC § 703. The partnership itself will not use NOL or capital loss carryover deductions, since these deductions are taken at the partner level. Distributive shares of the partnership tax items are allocated to each of the partners, according to their agreement, unless that agreement does not meet the requirement for having “substantial economic effect” or violates Subchapter K anti-abuse rules. In that event, the items will be allocated based on the partners’ interest in the partnership as determined under IRS regulations. IRC § 704.

Some items must be tracked and stated separately because they will have a different effect on a partner’s tax calculation based on the

partner's tax particular tax attributes (e.g. capital gains and losses). IRC § 702.

The partnership will prepare and file an information return showing the calculation of all the tax items under federal tax substantive rules. See IRS Form 1065. The partnership will also prepare information returns to report to each partner that partner's share of the tax items. See IRS Schedule K. The partners will then report the tax items on their own returns, treating those tax items appropriately based on the character of the items and the partner's other tax attributes.

- C. Partnership Acquires Property - The partnership may act to acquire property from third parties using partnership resources. If it does so, it will track the tax basis in those assets, including any depreciation expense, again, using rules for unincorporated businesses.
- D. Partnership Disposes of Property – The partnership may generally have two kinds of property—property acquired from third parties and property contributed by partners. If the property was acquired from third parties, the gain or loss (proceeds from disposition minus tax basis) will be treated as gain or loss to be allocated generally based on the partners' agreement. But if the property was contributed, then the built-in gain or loss at the time of contribution will be allocated back to the contributing partner.
- E. Partnership Incurs Liabilities – Partnership liabilities may arise from differing events. For example, a partner may contribute property that is subject to a creditor's lien or partnership may, itself, obtain credit which may or may not be effectively guaranteed by one or more partners individually. Subchapter K has specific rules for how partners' capital and outside basis are affected by these liabilities—for example, a partner who guarantees a partnership liability may receive an increase in that

partner's outside basis, which in turn will allow the partner to receive greater distributions before recognizing any gain (as discussed below).

- F. Partnership Makes Non-Liquidating (“Current”) Distributions – Current distributions are never taxable events for the partnership and are generally nontaxable events for the partners with three primary exceptions. The first is if the distribution, in terms of cash or tax basis in assets, exceeds the partner's outside basis. In that case, the partner will recognize gain. The second is where the partnership distributes property that had a built-in gain or loss when contributed. In that case, the built-in gain or loss will generally be recognized and allocated to the contributing partner at the time of the distribution. And the third is in the case of a “disproportionate distribution” of ordinary income assets. See IRC §§ 704 (c), 707, 737, and 751.
- G. Partner Transfers Partnership Interest – In the course of a partnership's existence, it is common for partners to transfer ownership interests. This transfer may result in a gain or loss if the partner's outside basis is less than or greater than the amount received for that interest. With certain exceptions, this gain or loss is generally considered a capital gain or loss. IRC § 741. In addition, other rules may require or allow that the partnership restate certain amounts tracked to show the original partners' capital and share of tax basis in partnership assets so that the partnership can accurately reflect the gains or losses accruing from operations for the new partner versus the old partners. See IRC § 754 and 743(b).
- H. Liquidating Distributions – The Subchapter K treatment of liquidating distributions generally treats the distribution as a current distribution—a return of capital to the partner or partners, but in some cases may treat the distribution as current income allocated to that partner. IRC § 736. Again, the portion that is treated as a distribution or a gain (or potentially loss) will be recognized depending on the partner's outside basis in the partnership interest.

9. IRC Provisions Intended to Prevent Abuse

The flexibility of partnership structures and the lack of transparency and complexity of many structures has allowed partnerships to be used to avoid tax. Subchapter K and IRS regulations contain a number of provisions that are designed to ensure that the tax effect of partnership activities matches the economic effect and that partnerships are not used to avoid otherwise applicable substantive tax rules. The most common of these provisions are briefly described here:

- A. General Anti-Abuse and Abuse of Entity Regulations – Under its regulations, the IRS has asserted the ability to ignore partnership treatment under the ordinary rules of Subchapter K, or otherwise reform a partnership or the tax consequences where those rules are used to avoid tax. To be respected, partnership related activities and transactions must have a substantial business purpose, must have economic substance, and the tax effect to the partners must reflect the economic effect on those partners.

In determining if these factors are met, the IRS may compare the tax paid under the partnership structure versus the tax that would have been paid had the partners engaged in the same transactions or activities apart from the partnership. The IRS regulations also provide for rules that effectively allow the IRS to ignore the partnership for certain purposes and to determine tax liability as if the partners were acting separately (or as an aggregate). Reg. §1.701-2.

- B. Substantial Economic Effect and Related Provisions – Special allocations—allocations of partnership tax items that do not match the partner's interest in the partnership—must have “substantial economic effect.” See § 704(b). To have substantial economic effect under IRS

regulations, special allocations must meet the tests adopted to show that the tax effect matches the economic effect, and must not violate other rules.

To meet the tests, the partnership must keep partner capital accounts in accordance with IRS rule and the partnership agreement must provide that upon liquidation, distributions will be made in accordance with positive balances in the partners' capital accounts. Any partner with a deficit in her capital account must be unconditionally obligated to restore that deficit (also called the “make-up” provision) or must agree to an offset—an allocation of other items to offset the deficit. Moreover, special allocations will not be allowed if their effect is to substitute items that have a different tax treatment but the same economic effect (e.g. capital gains in place of ordinary income). Also, special allocations cannot have a transitory effect where the allocations in one year are done to reduce the tax liability, but the resulting economic effect is reversed in other years where there is no, or less, effect on tax owed.

- C. Tracking “Hot” Assets – So-called “hot” assets are those that give rise to ordinary income rather than capital gains—generally inventory and receivables. Under IRC § 751, a partner cannot turn income from these hot assets into capital gains through the sale of a partnership interest or a distribution from the partnership. Instead, any gain related to these assets will be treated as ordinary income.
- D. Disguised Sale Provisions – Under IRC §§ 704(c), 707(a)(2)(B) and 737, partners may generally not use a partnership to avoid gain on the transfer of assets, including a partnership interest, that have accrued to the partner (“built-in gains”) and may also not effectively shift built-in losses to others through a partnership form.

- E. Transfer Pricing – IRC § 482, which is intended to prevent improper income shifting by use of related entities, applies to “two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests . . .” The IRS’s use of § 482 in the partnership area primarily involves foreign partners and partnerships or transactions between the partner and the partnership.

As with transactions between related domestic corporations, however, the IRS has little reason to use IRC § 482 to redistribute tax items between domestic partnerships. But, as with domestic corporations, states will generally have more reason to use IRC § 482-type authority where transactions between related entities effectively reduce state taxes by shifting income. Moreover, since the use of any kind of combined filing for partnerships is not widespread and may be impractical, transfer pricing may be even more important for closely related partnerships than for corporations.

10. International Tax Provisions

The international tax rules applied to partnerships have been, and still are, exceptionally complicated. The rules for recognizing and sourcing the income of U.S. partners from foreign partnerships and foreign partners from domestic partnerships make the state allocation and apportionment rules appear simple in comparison. And states generally conform to these international recognition and sourcing rules. Therefore, a comprehensive analysis of these rules is not only beyond the scope of this working draft, but may be largely unnecessary.

Still, a general understanding of these rules may have shed some light on how income can be sourced—as well as the reporting and record-keeping that may be imposed on partners and partnerships.

Because the Tax Cuts and Jobs Act of 2017 (TCJA) made important changes and clarifications in how a partner’s “out-going” and “incoming” activities and investments may be taxed, this section focusses on these post-2017 rules only.

NOTE: Federal sourcing rules (IRC §861-865) generally apply at the partnership level but there are important exceptions, where the rules essentially look through to and apply at the partner level. The most important of these will be discussed further below. Other exceptions to the rules below may exist but are beyond the scope of this discussion.

A. U.S. Partners and Foreign Partnerships

- (1) Transfers of Built-In Gain Property to Foreign Partnerships – In the international context, there is an exception to the normal rule that contributions to a partnership are non-recognition events, even where the contribution is an asset with a built-in gain. Under federal regulations, if assets with built-in gains are transferred by a U.S. person to a foreign partnership (as defined in IRC §721), in exchange for a partnership interest, the gain that would ordinarily be deferred will generally be recognized currently. The exception to current recognition is if the partnership adopts a remedial allocation to ensure the eventual recognition of the built-in gain by the contributing partner.
- (2) Foreign Partnership Income –
 - (a) Generally – A U.S. partner in a foreign partnership that is treated as a partnership for federal and foreign tax purposes is generally treated the same as if the U.S. partner held foreign assets and operations directly. The U.S. partner will be taxed on U.S.-sourced income, and to the extent the partner must include foreign-sourced income, the partner may take a credit for taxes paid.

- (b) Check-the-Box Rules – Under IRS check-the-box rules, an entity may be organized in a manner that would allow it to be taxed as a partnership—both domestically and in other jurisdictions—but may elect to be taxed as a corporation in the U.S. or in those other jurisdictions, resulting in what are called “hybrid” entities. Most often the term “hybrid” refers to an entity taxed as a partnership in the U.S., but as a corporation in a foreign jurisdiction. “Reverse hybrid” refers to an entity taxed as a corporation in the U.S., but as a partnership in a foreign jurisdiction. A hybrid or reverse hybrid may be domestic or foreign—meaning the entity is organized in the U.S. or another jurisdiction. The rules for determining how this hybrid treatment affects income recognition, sourcing, and foreign tax credits are exceptionally complicated.
- (c) CFC Rules in the Partnership Context – Controlled Foreign Corporations (CFCs) are subject to special treatment under federal law. In general, a CFC is a foreign entity that is controlled by U.S. owners. Each U.S. owner may then be subject to certain income recognition rules if that owner holds a certain ownership share.

Partnerships come up in the CFC context in two primary ways: (1) a U.S. shareholder may hold an interest in a hybrid foreign partnership (treated as a corporation for foreign tax purposes) which is a CFC under check-the-box rules, or (2) a U.S. person may have an interest in a domestic partnership which owns shares in a CFC. In the second case, the U.S. partner in the domestic partnership would be an indirect shareholder of the CFC. In either case, Subpart F may apply to require current recognition of income by the U.S. shareholder, even if there is no current distribution made by the CFC. In the second case—where the U.S. person is an indirect shareholder—under recent IRS regulations, the determination of whether the shareholder must

include Subpart F income is made at the partner level, looking through the partnership owner and attributing a pro-rata number of shares held by the partnership to each partner.

- (3) Sale of a Foreign Partnership Interest – Since many foreign partnerships are treated as some type of hybrid under check-the-box rules, the sale of ownership interests in those entities may depend on how the U.S. rules would apply to the entity, as it has elected to be treated. This may also affect the ability of owners to get the benefit of credits for taxes paid under U.S. treaties.

B. Foreign Partners and U.S. Partnerships

(1) U.S. Partnership Income –

- (a) Distributive Share – A foreign partner will generally be subject to U.S. tax on the distributive share of income of a U.S. partnership, with certain limited exceptions. See IRC §875(1) which provides that the partnership’s trade or business in the U.S. will be attributed to its partners for purposes of determining the source of their income. This rule applies to both general and limited partners, regardless of ownership share, and it also applies at the partnership-level in multi-tiered partnership structures—so that the source of the income follows that income through the upper tiers. Therefore, to the extent the partnership has income that would be sourced to the U.S., the distributive share of that income will also be sourced to the U.S. in the hands of foreign partners.
- (b) Guaranteed Payments - If the domestic partnership agreement gives a foreign partner a guaranteed payment rather than a distributive share then, depending on the nature of that

guaranteed payment, it may alter whether the amount is considered U.S. income.

itself must withhold from the any distributive share to the buyer/transferee and report that amount as tax withheld on the potential gain from the sale of the partnership interest.

(2) Sale of a U.S. Partnership Interest –

- (a) Follows the Partnership P.E. – TCJA clarified how the gain/loss from the sale or exchange of an interest in a domestic partnership would be treated. Under §864(c)(8) and recent IRS regulation, if the sale is made by a foreign partner, a portion of the gain/loss may be treated as effectively connected U.S. gain or loss—and the existence of the requisite permanent establishment of the foreign partners will generally be presumed provided that the partnership had acquired a P.E. in the U.S. (Gains related to real property have long been clearly sourced to the U.S. See §897.) In general, the gain is sourced to the U.S. to the extent that, if the partnership sold all its assets, that cumulative gain would be sourced to the U.S.
- (b) Notice and Information Reporting – Under IRS regulations, the transferring partner must notify the partnership of the transfer and the partnership is then required to provide information to the partner sufficient for it to report and pay tax on any gain from the sale of the partnership interest sourced to the U.S. Regulations also provide for how these notice and required information reporting duties are handled where the foreign partner is an indirect partner that sells an interest in a partnership that has a partnership interest in a domestic partnership.
- (c) Withholding – In addition to notice and information reporting requirements, IRC §1446(f) requires that the buyer/transferee of the partnership interest withhold 10% of the purchase price from the foreign seller of the partnership interest. In some cases where the buyer/transferee fails to withhold, the partnership

ISSUE OUTLINE

This issue outline is a working draft and is subject to change.

Issues covered in detail are those where state rules or guidance either differ or where specific guidance is generally lacking.

For each issue covered in detail, the outline sets out the majority rule or approach, if there appears to be one. Otherwise the outline notes whether there are competing or alternative rules or whether guidance is generally lacking.

In some cases, the outline also provides basic examples to illustrate the issues and may also summarize further analysis.

Assumptions

This outline makes certain assumptions:

- General Constitutional Principles Apply – *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), and its progeny, apply generally to the taxation of multistate business income from partnerships. States, therefore, must have a substantial nexus with the income being taxed, the income must be fairly apportioned, and the tax must not be internally inconsistent. The outline also recognizes, however, that the U.S. Supreme Court has not fully addressed how these general principles may apply in the partnership context, especially to questions of nexus, and that state courts may be divided.
- MTC Model and Uniform Laws and Regulations are Relevant Guidance - The general provisions of UDITPA and the MTC's regulations implementing UDITPA will supply relevant guidance, where appropriate, to the taxation of partnership income unless there is a substantial reason for making an exception or adopting a different partnership-specific rule.

Locating State Tax Rules Addressing Partnership Taxation

State tax rules in the partnership area have been called “underdeveloped.” Three things may contribute to this impression. First, most states do not have anything like IRC Subchapter K—a set of tax rules devoted entirely to partnership taxation and the pass-through system. Rather, states typically include partnership-related provisions in the personal (individual) income tax statutory provisions and regulatory rules. They may also have separate partnership provisions in their corporate income tax statutes and regulations, to the extent corporate partners are treated differently.

Second, states typically don't address partnership tax issues in statutes and regulations in a comprehensive way. So, particular rules may be found in a state tax statutes and regulations, but they may also be found in rulings, case law, or forms and instructions. Often, an issue is addressed generally without any indication of exceptions—even though such exceptions may have been recognized. In some cases, there may be no clear rule for a particular issue or question in a particular state.

Third, most states have had difficulties auditing partnership income where the partnership structure is large or complex. The IRS faced these very same difficulties which caused Congress to enact the centralized partnership audit regime. Because audits can often be a means for raising and resolving issues, the lack of audits in this area no doubt contributes to the lack of guidance in some cases.

Issues - General Categories

Based on feedback received from the states and from the MTC Standing Subcommittee, the issue outline is divided into three general categories:

- Issues Related to Taxing Partnership Income
- Issues Related to Gain/Loss on Sale of a Partnership Interest
- Administration and Other Issues

ISSUES RELATED TO TAXING PARTNERSHIP INCOME/ITEMS

1. Issue - Jurisdiction, Nexus, and Related State Law Exceptions

NOTES:

- This Issue No. 1 addresses state jurisdiction and nexus questions related to the reporting and payment of tax on partnership income. Questions related to nexus to tax gains or losses from the sale of a partnership interest are addressed in the section on the treatment of those gains and losses, Issue No. 6, below.
- Questions related to whether income is business versus nonbusiness or operational versus investment income, and the extent to which these distinctions may affect the states' ability to tax, or the method of imposing tax, on partnership income are discussed under Issue No. 2, below.

Usage – “Jurisdiction” versus “Nexus”

This outline uses the term *jurisdiction* to refer to state authority to require general compliance with information reporting or other administrative obligations imposed on the partnership, and it uses the term *nexus* to refer to the connection the state has with the taxpayer-partner and the partner's income derived in the state. Use of these different terms is not meant to imply that there are necessarily different standards for when there is jurisdiction versus when there is nexus. But it does, perhaps, serve as a reminder that the connection between the state and the partner may often be through the connection with a partnership, and vice versa.

State Law “Exceptions”

In addition to discussing jurisdiction and nexus, this outline also recognizes that states may create general bright-line standards or thresholds for when

tax is imposed and may choose not impose tax or reporting requirements to the extent permitted by the Constitution. This outline attempts to anticipate the effect of some of these general state law exceptions.

Questions Where States Generally Agree

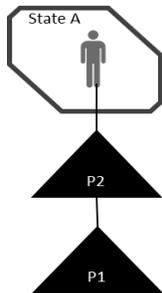
Based on review of various sources, there appears to be widespread general agreement on the following issues, which will not be addressed in further detail:

- **States have jurisdiction over partnerships doing business in the state or having other minimum connections with the state.**
- **States have nexus to tax partnership income, wherever derived, of resident partners.**
- **States have nexus to tax the partnership income of a nonresident or corporate general partner or any direct partner that is active in a partnership that conducts business in the state.** See Hellerstein, Hellerstein & Swain, *State Taxation* ¶20.08[2][a][i] General partners. Also see for example: Cal. Rev. & Tax. Code § 23101(d); 39 Colo. Code Regs. § 22-301.1(1)(c)(v); Conn. Gen. Stat. § 12-214(a)(3); Idaho Regs. § 35.01.01.620(02); Ky. Rev. Stat. Ann. § 141.010(25)(e); Mass. Regs. Code tit. 830, § 62.5A.1(3)(b); Mich. Comp. Laws § 206.621(1).

A. Jurisdiction to impose reporting requirements on a partnership based solely on a direct or indirect resident partner in the state.

- (1) QUESTION: Do states generally assert jurisdiction to impose reporting requirements on a partnership that does not do business in the state but has a *direct* resident partner?

ANSWER: Yes. See for example N.J. Rev. Stat. § 54A:8-6(b)(1); N.Y. Tax Law § 658(c)(1); Or. Rev. Stat. § 314.724(1).



(2) QUESTION: Do states generally assert jurisdiction to impose reporting requirements on a partnership which does not do business in the state or have any direct partners in the state, but which has an *indirect* resident partner in the state? Example: Partnership 1 is a partner in Partnership 2 which has a resident partner in State A. Neither Partnership 1 nor Partnership 2 do any business in State A.

ANSWER: Yes, however, many states do not specifically address this particular issue, but they also have not made an explicit exception.

B. Nexus to tax a nonresident or corporate partner—other than a general partner or direct partner that is active in the business—of a partnership deriving income in the state.

NOTE: As indicated in the introduction to this Issue No. 1, states agree that they have the ability to tax a direct partner that is a general partner or otherwise active in the business.

QUESTION: Do states generally assert nexus to tax a nonresident/nondomiciliary direct partner on the partner’s share of partnership income derived from the state, assuming this is the partner’s only connection to that state, and assuming the partner is not a general partner or active in the partnership business?

ANSWER: The majority rule appears to be Yes, but the authorities on this question are somewhat split.

- Authorities indicating the state does not have nexus:
 - *Lanzi v. Alabama Dep’t of Rev.* (Ala. Civ. App. 2006) – a plurality opinion holding that the state did not have jurisdiction to tax a

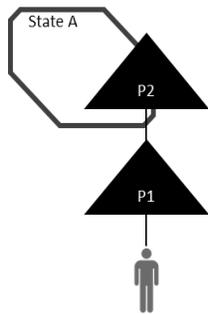
nonresident, passive, limited partner of a partnership managed in Alabama where the income came mainly from intangible assets.

- *BIS LP v. Director, Div. of Taxation*, 26 N.J. Tax 489 (N.J. Super. Ct. App. Div. 2011) – holding that an “investment” partner (a limited partner whose only activity was investment) was not unitary with and could not be taxed on income from its 99% interest in a limited partnership doing business in the state.
- Authorities indicating the state does have nexus:
 - See Hellerstein, Hellerstein & Swain, *State Taxation* ¶ 20.08[2][a][ii] Limited Partners.
 - *Borden Chemicals & Plastics, L.P. v. Zehnde*, 312 Ill. App. 3d 35, 726 N.E.2d 73 (App. 1st Dist. 2000) – holding that a nondomiciliary limited corporate partner could be taxed on the income of a partnership doing business in the state.
 - *Prince v. State Dept. of Revenue*, 55 So. 3d 273 (Ala. Civ. App. 2010) – distinguishing *Lanzi* and ruling that a nonresident limited partner could be taxed on the gain from an IRC § 338 sale of stock, treated as the sale of assets, of an S corporation that was doing business in Alabama.
 - *Wirth v. Commonwealth*, 626 Pa. 124, 95 A.3d 822 (2014) – holding that nonresident limited partners with an indirect interest in a partnership that operated a skyscraper in Pittsburgh were subject to tax and distinguishing *Lanzi* on the basis of the type of property owned.
 - *Preserve II, Inc. v Div. of Taxation*, 30 N.J. Tax 133, 2017 BL 363663 (Tax Ct. 2017) – holding that a 99% limited corporate partner could be taxed on income derived from a limited partnership doing business in the state (quoting Professor

Hellerstein’s treatise and a separate treatise by Professor Swain for support).

ANALYSIS: The authorities above appear to focus on limited versus general partners—but it is not necessarily the fact that limited partners have protection from partnership liabilities that matters. Rather, what matters is that limited partners often do not take an active role in the business. See Cal. Franch. Tax Bd., Legal Ruling No. 2014-01 (July 22, 2014).

C. Nexus to tax an *indirect* nonresident or corporate partner of a partnership deriving income in the state.



QUESTION: Do states generally assert nexus to tax a nonresident/nondomiciliary *indirect* partner on the partner’s share of partnership income ultimately derived from the state, assuming this is the partner’s only connection to that state? Example: Assume Smith is a partner in Partnership 1 which, in turn, is a partner in Partnership 2, which operates partially in State A. Also assume that Smith and Partnership 1 have no other connection with State A.

ANSWER: In general, yes, to the same extent they would assert nexus on direct partners—although the facts and circumstances may matter and the answer in some states may be unclear.

State rules may be clearer with respect to indirect corporate partners. See for example Mich. Dept. of Treas., Rev. Admin. Bull. 2014-5 (Jan. 29, 2014), and Wis. Stat. § 71.22(1r) which assert nexus generally over any corporate partner, direct or indirect, for tax on income earned by a partnership and derived within the state.

D. Factor-presence nexus standards.

QUESTION: Can states apply factor presence nexus standards in the context of partnership taxation?

ANSWER: Yes – such standards are typically applied at the partnership level. The MTC adopted a model factor presence nexus standard for partnerships that is applicable to partnerships as follows:

“Pass-through entities, including, but not limited to, partnerships, limited liability companies, S corporations, and trusts, shall determine threshold amounts at the entity level. If property, payroll or sales of an entity in this State exceeds the nexus threshold, members, partners, owners, shareholders or beneficiaries of that pass-through entity are subject to tax on the portion of income earned in this State and passed through to them.”

E. General state law exceptions to tax imposition.

(1) QUESTION: Might states’ “doing business” statutes exclude certain partners from tax?

ANSWER: This may be the case in some states. See *Swart Enterprises Inc. v. California Franch. Tax Bd.*, 7 Cal. App. 5th 497 (Cal. Ct. App. 2017) – holding that a purely passive corporate member of an LLC doing business in the states was not, itself, doing business.

(2) QUESTION: Do states provide specific exceptions for certain partnerships, particularly those engaged in passive investment activity?

ANSWER: A substantial number do. In addition to the *Lanzi* and *BIS* cases noted above, a number of states have statutes or rules that

define investment partnerships, either more broadly or narrowly. These state statutes often have particular tests that must be met by the partnership in order to qualify for this treatment, but the general focus is on identifying partnerships whose activities are investment activities and whose partners are mostly passive. *See for example*, Cal. Rev. & Tax. Code §§ 17955(a)(1)-(2) and (c)(1); N.M. Admin. Code § 3.11.14(C); Regs. Code tit. 830, § 62.5A.1(3)(b).

ANALYSIS: The exceptions made for investment partnerships appear to be based on reasoning that includes the nature of the partnership and its activities—that is, investment rather than operations—and the nature of the partners for whom the exception applies—that is, passive partners that do not engage in oversight or management of the partnership’s investing activities. There are differences in these exceptions for investment partnerships and so this may be an area where uniformity would be useful.

2. Issue – Sourcing of Partnership Income

NOTES:

- In the corporate income tax context, the U.S. Supreme Court has distinguished business or operational income from nonbusiness or investment income when determining whether a state may apportion that income using the taxpayer/owner’s apportionment factors. *Allied-Signal, Inc. v. Director*, 504 U.S. 768 (1992). Under UDITPA, separate specific sourcing rules are applied to nonbusiness or investment income.
- UDITPA provides that its rules for sourcing multistate income apply to “any taxpayer.” See Art. IV Sec. 2.

The sourcing of partnership income can be very complex because of the potentially complicated partnership structures and because taxpayer partners may be taxed as C corporations or as individuals. States have addressed these issues to an extent—but not as comprehensively as they might.

Assume, as a simple example, Partnership 1 conducts its business solely in State A. Partnership 2 conducts its business solely in State B, and owns 50% of Partnership 1. Partnership 2, in turn, is owned 50% by Individual and 50% by Corporation. For a particular item of income recognized by Partnership 1, the following are the possible approaches to sourcing:

- Alternative 1: Determine if the item is business or nonbusiness income based on indicia determined at the partner level—that is, based on how the income relates to the activities of Corporation and Individual, regardless of whether the income would be business or nonbusiness income to Partnership 2 or Partnership 1.
- Alternative 2: Determine if the item is business or nonbusiness income based on indicia determined at the level of Partnership 2 (the

partnership in which Corporation and Individual are direct partners), regardless of whether the income would be business or nonbusiness income in the hands of Partnership 1, and have that character flow through to the partners.

- Alternative 3: Determine if the item is business or nonbusiness income based on indicia determined at the level of Partnership 1, and have that character flow through to the partners unchanged by how Partnership 2 might relate to that income.
- Alternative 4: Determine if the item is business or nonbusiness income based on indicia determined at the level of Partnership 1, and if it is nonbusiness income, then that character would flow through to the partners, but if the character is business income, then this might be altered at the partner level based on the partners’ relationship to that income. (As discussed below, this appears to be the majority rule.)

A. Use of UDITPA to Source Income

QUESTION: Do states look to UDITPA generally to provide sourcing rules for partnership income or tax items?

ANSWER: Yes. As noted above, UDITPA provides that its rules apply to “any taxpayer” and a number of states have adopted UDITPA in some form, including this provision. Others have explicit guidance saying that UDITPA (or that state’s own apportionment and allocation rules which may be based on UDITPA) applies to partnership income generally—or may apply to certain kinds of partnership income.

See for example:

- Colorado Revised Statutes, C.R.S. § 39-22-109—which provides specific rules for partnerships but also allows partnerships to use UDITPA.

- Delaware Code, 30 Del. C. § 1623(d)—which provides that the state apportionment rules apply unless the income is allocated to the state.
- Kansas Form 120S – Partnership or S Corporation Income Tax Return Instructions - which provide instructions on apportioning and allocating pass-through income using the same UDTIPA provisions as for corporations.
- Administrative Rules of Montana, ARM 42.15.120 – Partnerships also use special apportionment rules adopted by Montana for application to corporate income tax.

B. Characterization of partnership income – generally.

QUESTION: Do states characterize items of partnership income generally as business/nonbusiness or operational/investment income?

ANSWER: Yes, with limited exceptions.

C. Application of traditional criteria.

QUESTION: Do states use the traditional criteria, including UDITPA or other rules adopted for C Corporations, in determining whether items of partnership income are business/nonbusiness or operational/investment income?

ANSWER: Yes, although some states may have special rules designating what is investment partnership income (and sourced to residence/domicile) or other partnership-specific rules.

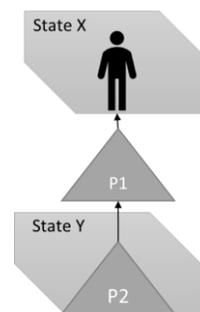
D. Treatment of guaranteed payments.

QUESTION: Do states distinguish guaranteed payments for different criteria or treatment?

ANSWER: Some states provide that guaranteed payments are treated like wages when paid to individual partners, particularly if the partnership is a service partnership and the partners are active in that business. Other states either have not addressed the issue or have addressed it only informally.

E. Determining business or nonbusiness character of pass-through income.

- (1) QUESTION: If income or some other partnership item were determined to be business or operational income (and apportionable) or nonbusiness or investment income (and allocable) applying traditional rules at the partnership level, does that income or other item retain that character when it passes through to a partner?



Example: Partnership 1 properly determines that a gain from the sale of an investment is nonbusiness income and allocable to State X. That income flows through tiered partner, Partnership 2, to Smith, a partner in Partnership 2, who is a resident of State Y. Should Smith report his share of the gain that flows through Partnership 2, from Partnership 1, to State X?

ANSWER: For the states that appear to have addressed this question generally, the majority rule is yes—with a few exceptions. See, for example:

- Ark. Code Ann. § 26-51-802(c)(2); Ark. Regs. 1.26-51-405; Arkansas Form AR1050: Instructions for Partnership Income Tax Return.
- Cal. Code Regs. tit. 18, § 25137-1(f).
- Colo. Rev. Stat. § 39-22-203(1)(a).
- Ill. Admin. Code tit. 86, § 100.3500(b)(2).
- Code of Massachusetts Regulations, 830 CMR 62.5A.1, Non-resident Income Tax – stating explicitly: “The income of a pass-through entity that derives from or is effectively connected with the conduct of a trade or business or the ownership of real or tangible personal property in Massachusetts retains its character as it passes through a tiered structure of pass-through entities before becoming income to the non-resident. Thus, income that is derived from a trade or business does not convert to non-business-related income as it passes through a series of entities.”
- Missouri Regulations, 12 CSR 10-2.190.

A number of states do not explicitly address this particular question, but it may be assumed from their general rules applied to partnerships that the determination of the character of the income would be made at the entity level. Also, the question of whether the character of income is retained when it flows through multiple tiers is often not specifically addressed in state statutes or regulations, although it may be addressed elsewhere.

ANALYSIS: In general, this “flow-through” of the nonbusiness character of the income to the partners, whether directly or through

multiple tiers, matches the federal treatment. Under Subchapter K and IRS regulations, the character of income is determined at the partnership level and flows through, even in a multi-tiered structure. See IRC Reg. §1.1362-2(c)(4)(ii)(B)(4), §1.1362-2(c)(5) Ex. 4.

- (2) QUESTION: Does the answer to (1) depend on whether the partner is majority/minority, general/limited, or active/passive?

ANSWER: Probably. States appear to recognize that partnership income can nonbusiness income in the hands of the partners even if it was determined to be business income in the hands of the partnership that recognized that income. Therefore, this rule that the character of the partnership income flows through may hold only where the character is determined to be *nonbusiness* income in the hands of the partnership recognizing that item. If, instead, the income was determined to be *business* income in the hands of the partnership, it might still be nonbusiness income in the hands of the partners. In determining whether the income is nonbusiness income the hands of the partners, the state may look to the nature of the partner and whether the partner is a minority, limited, or passive partner.

- (3) QUESTION: Are “investment partnerships” treated differently?

ANSWER: Yes—the majority of states recognize such partnerships, to some extent, and provide that the income is essentially treated as nonbusiness income in the hands of nonresident partners, so that it is subject to sourcing to the residence of those individual partners, and sometimes to the domicile of corporate partners. A number of states, however, do not recognize this difference explicitly and a few states specifically provide that investment partnership income is treated no differently.

See, for example:

- Ala. Admin. Code r. 810-3-24.2-.03(3)(b).
- Ark. Code Ann. § 26-51-202(e).
- Cal. Rev. & Tax. Code § 17955(a)(2).
- Conn. Gen. Stat. § 12-214(a)(3)(C); Conn. Gen. Stat. § 12-213(a)(26).
- 35 ILCS 5/305(c-5); Ill. Admin. Code tit. 86, § 100.3500(d)(1).
- North Carolina Personal Taxes Bulletin 2020, Section VII(15).

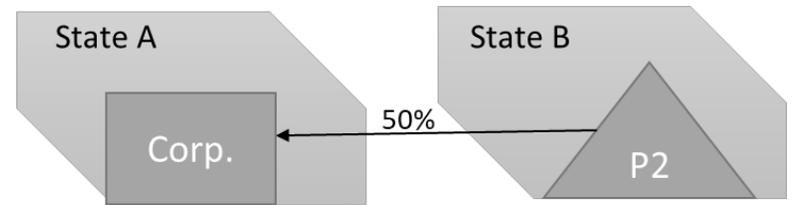
But see:

- Utah Private Letter Ruling No. 96-151, holding that a nonresident partner's income from an investment-type partnership would still be sourced to the state.

F. Apportionment and use of combined income and factors.

Application of apportionment to partnership income, unlike the application of specific sourcing for nonbusiness income, discussed above, raises the question of how apportionment is done when there is a direct or indirect corporate partner with its own income and factors, or whether there is one or more tiered partners with separate income and factors. Two simple examples illustrate how different approaches will lead to different results:

Example 1: Corporation is a 50% partner in Partnership. Corporation operates entirely in State A. Partnership operates entirely in State B. Both States A and B use single-sales factor apportionment. The income and factors of Corporation and Partnership are as follows:



	Income	State A Sales	State B Sales	Total
Corp.	\$1 million	\$8 million	\$0	\$8 million
Partnership	\$1 million	\$0	\$4 million	\$4 million

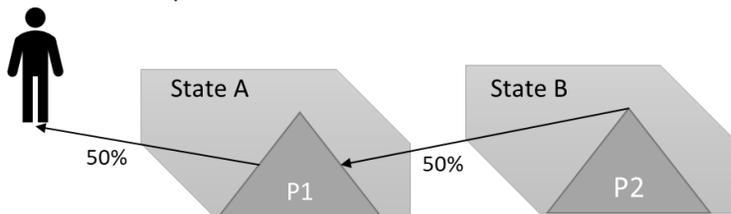
Assume only partnership's factors are used:

Partnership income of \$1 million X 100% State B = \$1 million sourced to State B X 50% = **\$500K Corporation income sourced to State B**

Assume corporation and partnership income and factors are combined:

- Corporation combined income = \$1 million + 50% of \$1 million = \$1.5 million
- Corporation combined State B sales factor = 50% of \$4 million = \$2 million divided by \$8 million + 50% of \$4 million = 20%
- 20% combined sales factor X \$1.5 million combined income = **\$750K Corporate income sourced to State B**

Example 2: Smith is a 50% partner in Partnership 1 which is a 50% partner in Partnership 2.



	Income	State A Sales	State B Sales	Total
P1	\$1 million	\$8 million	\$0	\$8 million
P2	\$1 million	\$0	\$4 million	\$4 million

Assume that Smith reports income based solely on the separate factors of P1 and P2:

Smith would have income in State B of \$1 million X 50% X 50% = \$250K

Assume P1 and P2 are combined for purposes of determining Smith's income apportioned to State B:

- P1 has combined income of \$1 million + 50% of \$1 million = \$1.5 million
- P1 has a combined State B sales factor of 50% of \$4 million = \$2 million divided by \$8 million + \$2 million = \$10 million = 20%
- P1 income apportioned to State B = \$1.5 million X 20% = \$750K
- **Smith income apportioned to State B = 50% of \$750K = \$375K**

- i. QUESTION: For corporate partners that apportion items of partnership income along with other apportionable income, do states generally combine (“roll up”) a portion of the partnership factors to include with the corporate partner’s factors?

ANSWER: Yes. This is clearly the majority rule among the states that have explicitly addressed the issue. See, for example:

- Delaware Code, 30 Del. C. § 1623(d)(2).
- Hawaii Administrative Rules, HAR § 18-235-29-04(a).
- Georgia Rules and Regulations, Ga. Comp. R. & Regs. r. 560-7-7-.03(5).
- Indiana Administrative Code, 45 IAC 3.1-1-153(b)— but only to the extent that the corporation and the partnership are part of a unitary business.

ANALYSIS: As Indiana’s rule and rules in other states may indicate— states may choose whether to include partnership income which is otherwise not sourced as nonbusiness income into the income of the corporate partner, to be apportioned using only the corporate partner’s factors. One circumstance in which this might arise is where the partnership income is operational income to the corporate partner even though that partner owns less than a controlling interest in the partnership and would, under state rules, not be considered “unitary” with the partnership.

- ii. QUESTION: In a tiered partnership structure, do states generally combine partnership factors from the various tiers when apportioning income?

iii. ANSWER: Unclear.

3. Transfer Pricing

- A. QUESTION: Do states use transfer pricing to determine the proper treatment of intercompany transactions between related partnerships?
- B. QUESTION: Do states use IRC § 482 authority to alter the allocation of partnership items resulting from intercompany transactions.

4. State Adjustments

- A. Is it clear that under state law, as under the IRC, it is the rules for unincorporated businesses that apply to the computation of state net income or tax items?
- B. Is it clear under state law that any adjustments required to be made to individual or corporate federal taxable income also have to be made to partnership income allocated to individual or corporate partners?
 - (1) Under the IRC, partnerships compute their income using rules for unincorporated businesses – so if the adjustments apply only to corporations, the adjustment would, presumably, have to be made at the partnership level.
- C. Should adjustments required to be made to federal tax items under state law be reported by the partnership which recognized the item, or the taxpayer-partner, or both?
- D. If state adjustments require the separate tracking of partnership-level tax attributes, particularly basis in partnership assets, can partners rely on information available to determine that adjusted basis.

- E. If state adjustments require the separate tracking of partner-level tax attributes (e.g. outside basis, partners' capital accounts, etc.) for state tax purposes, how does this affect partners who may have sourced income to the state as residents or non-residents over the relevant period.
- F. Do any states that otherwise limit the use of NOL deductions explicitly limit the partners' use of NOLs or excess expenses generated by partnerships—for example, limiting the ability to offset an NOL carryover from one business against the income of another?

ISSUES RELATED TO SALE OF A PARTNERSHIP INTEREST

NOTE ON RESIDENCY-BASED TAX: This outline assumes that a state may, consistent with applicable constitutional principles, include in income subject to state tax 100% of the gain or loss from a resident partner's sale of a partnership interest. This outline also assumes that there is no constitutional prohibition against a state treating as apportionable income the income that could otherwise be taxed 100% by that state.

5. Nexus – Sale of a Partnership Interest

- A. QUESTION: Do the answers to the questions as to the nexus to tax direct or indirect partners on their operating income (above) change when considering tax imposed on the gain from the sale of a partnership interest?

ANSWER: As noted above, most states appear to generally assert nexus over a nonresident or out-of-state corporate partner on the basis of holding a direct or indirect interest in a partnership doing business in the state.

Therefore, while states may not address the question of nexus to tax the sale of a partnership interest directly, it is reasonable to assume that a

state will assert nexus unless it specifies otherwise. However, for individual partners, the ultimate answer to the nexus question in a particular state may be influenced by the state's statutory provisions specifying what is state-sourced income and whether the state applies the general principles developed in the corporate income tax context, including UDITPA, to nonresidents.

There have been very few reported cases addressing the question of nexus to tax a nonresident on the sale of a partnership interest. The following cases are notable:

- *Corrigan v. Testa*, 149 Ohio St. 3d 18, 73 N.E.3d 381 (2016). This is perhaps the only case involving nexus to tax a nonresident partner on the sale of a partnership interest that has gone all the way to the state's highest court. Ohio generally imposed tax on such gains realized by any nonresident owner that held a 20%-plus interest during the three years prior to sale. The gain was apportioned using the partnership's factors for that period.

In this case, the taxpayer acquired a majority interest in the business, an LLC, which was already operating throughout the country. Corrigan was the managing member of the LLC and engaged in oversight of the business. The court nevertheless found that he was not active in the business and was not engaged in unitary activities with respect to the business. So, while here was no doubt that this majority partner was taxable on the income of the partnership, apportioned to Ohio, on a pass-through basis, the Ohio Supreme Court held that the gain from the sale of the interest was different. The court distinguished the gain as "investment" income and also determined that nexus was lacking over the transaction. The court also focused on the need to use the investee's apportionment factors to source the gain—as

opposed to the traditional method of sourcing such gains from the sale of personal intangible property to the owner's domicile.

- *T. Ryan Legg Irrevocable Tr. v. Testa*, 149 Ohio St. 3d 376, 75 N.E.3d 184 (2016)(cert. denied). Shortly after Corrigan was decided, the Ohio Supreme Court distinguished and limited it. In addition, a concurring opinion filed in the later case would have held that *Corrigan* was wrongly decided. The concurring opinion would have held that *Corrigan* was wrong to decide that the default situs for investment income was domicile and, instead, would have determined that using the type of apportionment provided for under Ohio law was permissible. The concurrence likened this to the sale of real estate located in the state.

6. Sourcing – Gain/Loss on Partnership Interest

NOTE: The sourcing rules for gains/losses from the sale or transfer of a partnership interest are much more developed in the corporate income tax context. In general, if the gain/loss is business or operational income, it is subject to apportionment, and if is nonbusiness or investment income, it is most often sourced to the corporation's domicile. There are a few states, however, that appear to assert the ability to use a ratio based on the partnership's presence or activities to allocate nonbusiness/investment gains and losses.

But even in the corporate tax context, the rules for how apportion the gain (whether business or nonbusiness) may raise unanswered questions, such as how to treat the gain when calculating the sales factor. Nor has the Supreme Court ever weighed in on the question of whether a nonbusiness/investment gain may be sourced using the investee's factors or presence in a state. See *MeadWestvaco Corp. v. Ill. Dep't of Revenue*, 553 U.S. 16, 31, 128 (2008). Also, some states continue to maintain a "liquidation exception" to the definition of

business income—either as an interpretation of state law, or an interpretation of the constitutional limits of apportionment generally.

In the individual income tax area, how gain/loss on the sale of a partnership interest would be sourced is much more uncertain. The lack of clear rules is an issue because the concept of taxing an individual's gain from the sale of a partnership interest on an apportioned basis is not self-executing. Unlike corporations, individuals typically do not have their own apportionment factors. Specific state rules are needed in order to implement this approach. Therefore, without these rules, some may presume that the gain/loss will be allocated to domicile.

Only a few states have currently adopted such specific apportionment rules for individuals, and those rules differ. See for example:

- IDAPA 35.01.01.266.d. "Gains or losses from the sale or other disposition of a partnership interest or stock in an S corporation are sourced to Idaho by using the Idaho apportionment factor for the entity for the taxable year immediately preceding the year of the sale of the interest or stock."
- Me. Rev. Stat. Ann. tit. 36, § 5211(16-A)(F) – "Gross receipts on the sale of a partnership interest must be sourced to this State in an amount equal to the gross receipts multiplied by the ratio obtained by dividing the original cost of partnership tangible property located in Maine by the original cost of partnership tangible property everywhere, determined at the time of the sale."
- 1708 Mass. Regs. Code tit. 830, § 62.5A.1(3)(b)(8)—A gain/loss that is "business income" would be subject to apportionment over the period during which the interest was held.

A. QUESTION: Do states generally have a clear, explicit rule—either looking to the domicile of the owner or apportioning the gain/loss in particular circumstances?

ANSWER: The answer is unclear. It is more likely that there are clear rules in the corporate income tax context. The traditional rule for individuals is that gains from sales of partnership interests were sourced based on the individual's domicile or residency.

B. QUESTION: In determining how gain/loss on the sale of a partnership interest will be sourced, do states look to whether the gain/loss is "business," "unitary," or "operational," versus "nonbusiness," or "investment" income, in the hands of the partner?

ANSWER: It appears that the majority of states do consider this type of distinction for both corporate and individual partners—but it is not clear for a number of states, especially in the context of individual income tax.

C. QUESTION: If the state recognizes that the concepts in B above apply, does that state nevertheless recognize a liquidation exception to the definition of business income and would that exception apply to the sale of a partnership interest.

ANSWER: It appears that a minority of states may still recognize a liquidation exception.

D. QUESTION: Does it matter whether the partner is an individual or a corporation?

ANSWER: As noted above, the rules for corporations tend to be more certain. The majority of states base the sourcing of the gain/loss from the sale of a partnership interest on whether the gain/loss would be in the nature of apportionable income under the state's statutes or

interpretations of constitutional limitations. For individuals, not only is it less clear whether the states will apply these same principles, it is not always clear how they will apply. (For example, how will the state determine if an individual is unitary with the partnership.)

- E. QUESTION: Does it matter whether the partner sold a direct partnership interest or was allocated a share of the gain/loss through tiered partners?

ANSWER: Unclear.

- F. QUESTION: In addition to the considerations outlined above, or instead of those considerations, do states look to whether the partner is a majority/minority, general/limited, or active/passive partner?

ANSWER: While the answer is unclear in most states—that is, it has not been explicitly addressed—these considerations at least appear likely to have some bearing on sourcing in some states.

- G. QUESTION: Do states that recognize some sort of “investment partnership” treat the gain/loss on sale of an interest in such partnership differently?

ANSWER: It appears that states that recognize some sort of investment partnership will treat the gain/loss on the sale of an interest in such partnership as sourced to the domicile of an individual investor.

ADMINISTRATION AND OTHER

7. Credits for Tax Paid

- A. How should the credit be determined?

- (1) Based on actual tax paid?
 - (2) Based on apportioned share of income at the resident effective rate?
 - (3) Other?
- B. Should credits be given for foreign taxes paid, and if so, to what extent?

8. Information Reporting

- A. What types of state-level information reports are necessary to ensure compliance with rules?
- (1) Do the application of the rules vary depending on whether the partnership files a composite return?
 - (2) Do the application of the rules vary by size of the partnership?
- B. How are partnerships audited and should states consider a centralized audit regime, similar to the federal regime recently adopted?
- C. Withholding and Composite Returns
- (1) Should such returns be required and if so, when?
 - (2) Should corporate partners be included in the composite return?
2. Other
- A. Given the complexity of partnership taxation, should some sort of entity level tax in lieu of pass-through tax on the partners be applied?
- (1) How would such a tax function?

(2) Should the tax be elective?

9. Centralized Audits

10. Partnership Level Taxes Paid in Lieu of Taxes on Partners

As part of a work-around to the so-called SALT deduction cap imposed by the TCJA, some states have developed a partnership level tax to take the place of taxes that would otherwise be paid by partners but could not be deducted for federal tax purposes. In the most common of these taxes, the partnership elects to pay the tax and the partners receive a credit for taxes paid.

DISCUSSION DRAFT